

The Supply Side of Choice

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NEW SCHOOL CREATION IS KEY TO SUCCESS OF CHOICE

For the last two decades, the struggle over school choice has focused on freeing up parents to choose. It continues to this day, with growing success in the forms of public and private voucher programs, charter school laws in 40 states and the District of Columbia, and state and federal laws that require school districts to offer options for children in failing schools.

For a long time, it was so difficult to win freedoms for parents that supply-side questions never came up. In localities like New York City, Dayton, Ohio, and Washington, D.C., choice programs were limited to a fraction of all families, and there were enough empty spaces in existing parochial and independent schools to serve most of them.

However, as choice programs grow school availability becomes a constraint. In Denver, for example, an open enrollment rule allows every family to choose a public school outside their neighborhood, but the options are so mediocre, and so alike, that few families bother to express a preference. In Seattle, where all families must express a preference, there is no mechanism to create new options. Consequently, hundreds of students are forced to attend schools that were their third or fourth choices.

Throughout the country, the supply side is becoming a constraint on the expansion of choice. Dozens of urban districts required by No Child Left Behind to offer choices to children in low-performing schools have been unable to do so: higher-performing schools are full and the only available alternatives are low performing. In Baltimore, 27,000 students, a third of the district's total enrollment, were eligible to transfer to higher-performing schools, but only 301 seats in such

schools were available. In Chicago, 270,757 students were eligible to transfer but only 1,097 seats were available at 38 schools. There were 20 applicants for every available seat, but nearly a quarter-million eligible families made no effort to choose, probably in recognition that there was no place to go. Earlier, the state of Pennsylvania had hoped to turn Philadelphia schools over to independent providers but was limited by the capacity of the few national and local providers.

Thus we come full circle. An original impetus for the choice movement was to empower poor families who cannot move to affluent suburbs or pay private school tuition. Regarding such families as a captive audience, districts have not developed the capacity to provide options. Declaring that poor families may choose means nothing unless there is some mechanism to create new schools among which they can choose.

Economic theory says that if the demand for any good or service is strong enough, some entity will arise to meet it. This is probably the case with schools, at least in a situation that fits the theory (free movement of customers, customers' ability to pay, modest costs of entry, and clear rules of competition evenly applied). On the purely private side of the market for schools, the existence of a large number of parents willing to pay private-school tuition apparently stimulates a supply response.

On the public side of the market for schools, however, when governments, not parents, pay for schooling, there are forces that hold down the supply. Even when state law allows for publicly funded charter schools, vouchers, or contracts between school districts and independent providers, the decks are often stacked against new options.

Families can keep their children in public schools free of charge, but if they choose schools not offered by their local district they often have to pay something—for transportation, books, supplementary tuition, or uniforms. Voucher and charter programs often provide much less money per pupil than is available to school districts. Cleveland's voucher program started by offering private schools less than half the per-pupil amount available to the local

school district. California's two unsuccessful voucher initiatives offered between one-half and two-thirds of the statewide average per-pupil expenditure. Charter schools generally receive between 60 and 80 percent as much money as district-run schools.

For groups interested in creating new schools, the costs of entry are high, both because starting a school is difficult and because school districts use their monopoly advantages—especially delays in paying bills, control of school buildings, cozy relationships with building inspectors, and existing student transportation—against newcomers. Finally, once the new schools are up and running, the playing field is anything but level, with district-run schools receiving free services that privately run schools must pay for, and state and local governments scrutinizing the operations of independently run schools much more closely than those run by districts. Even in states with charter or voucher laws, the legal rights of private schools that receive public funds are poorly defined, and many school districts act as if they can terminate agreements with independent providers whenever they deem it convenient. One large independent school provider, Edison, enters contracts with school districts but informally promises to “leave when we are not wanted” whether or not it has fulfilled all its contractual obligations.

Under these circumstances it is not clear how soon, or how well, the market will provide schools in response to families' hopes for options. A failure on the supply side can have adverse consequences for children who need better schools than are now available to them. It can also have adverse political consequences, as groups that oppose expansion of choice can point to the weak supply response as evidence that choice does not benefit children. This claim is unfair, since the choice opponents who make it are the same people who engineered a hostile environment for new schools. It is, however, effective politics.

A weak supply response puts the whole choice movement at risk. When the number of new schools is smaller than the demand, opponents can claim that only conventional public school districts can be trusted to provide a school for every child. When new schools are

plentiful, but include many of low quality, efforts to increase regulation or cut back on the numbers of new schools are authorized.

This article looks closely at the supply side of choice. It reviews the factors that prevent the emergence of a large number of good new schools of choice and identifies ways those factors can be overcome, both by changes in policy and by private investment.

FACTORS LIMITING THE NUMBER AND QUALITY OF SCHOOLS

C. Northcote Parkinson observed that a properly worded classified advertisement could ensure the successful recruitment of any contractor or individual, even a prime minister. Similarly, the wrong advertisement could drive away the best qualified and ensure that only the less capable would apply. Consider this as a classified advertisement for a prime minister:

Hours of work: 4 A.M. to 11:59 P.M. Candidates must be prepared to fight three rounds with the current heavyweight champion. Candidates will die for their country, by painless means, on reaching age of retirement (65). They will have to pass an examination on parliamentary procedure and will be liquidated if they should fail to obtain 95% marks. They will also be liquidated if they fail to obtain 75% votes in a popularity poll held under Gallup rules. They will be invited to try their eloquence on a Baptist Congress, the object to induce those present to rock and roll. Those who fail will be liquidated . . .

As Parkinson comments, "if this advertisement has been correctly worded there will be only one applicant and he can take office immediately. But what if there is no applicant? That is proof that the advertisement needs re-wording. We have evidently asked for something more than exists." A similar advertisement for providers of new schools of choice might read as follows:

Wanted: excellent new schools able to succeed quickly with children who have learned little in several years of public school. Applicants must find and finance their own facilities and will be paid only for children enrolled. Obligations to handicapped stu-

dents and other terms and conditions will vary from time to time. Competing public schools will have significant financial advantages, including services provided by district central office. Board that oversees public schools will also judge new schools' performance and may change key rules including student eligibility to choose at any time. Claims for payment will be closely scrutinized and payments are likely to be late.

These terms of employment are luridly unattractive, but nonetheless real. Charter schools often attract children who have struggled for years in public school, and in most states they must find their own facilities and finance them from amounts received for student tuition. Obligations to handicapped students differ from state to state and can change depending on federal and state reinterpretations of disabilities law. Local districts often pull the rug out from under their own magnet schools by changing student eligibility rules, and districts in Florida and elsewhere are finding ways to squeeze down on eligibility for choice plans. Charter and voucher schools must pay for financial and other non-instructional services from their teaching budgets, and school boards, who regard such schools as competitors, nonetheless oversee performance and enforce rules. State laws regarding charters and voucher schools are in constant flux, with opponents constantly trying to impose new rules and impose collective bargaining rules. Schools of choice often depend on school boards, notoriously slow payers, for their incomes.

The existence of more than 3,300 charter schools indicates that some people are willing to work under such circumstances, but adverse conditions make schools financially unstable and probably drive away many competent providers who believe the risks of failure are too great.

The early difficulties of charter schools, including some schools' disbanding before or shortly after opening and the generally low performance of new schools in their first two years of operation, might be due to the fact that some groups willing to accept these adverse terms are uninformed about the challenges of starting and running

successful schools. True, charter-starters include "cause" groups and dedicated educators willing to invest their own money. But even such groups must eventually make ends meet. In the long run, there is no substitute for conditions that allow schools of choice to be competent, attractive, stable, and solvent. What factors limit the supply of schools? The classified advertisement hints at them.

LOW PER-PUPIL FUNDING

Until enactment of the Washington, D.C., public school voucher law, few voucher programs, whether publicly or privately funded, paid much more than half the regular public school per-pupil expenditure. The same is true of charter schools, which, depending on state laws, either get a set percentage of total per-pupil expenditure (from 75 to 95 percent) or only that fraction of total per-pupil expenditure provided by the state (typically 50 to 80 percent). From these amounts, charter schools must pay for administration and teaching staff, service debt, obtain insurance and legal representation, pay for any student transportation and ancillary student services they choose to offer, and rent school facilities.

Low funding limits schools of choice in bidding for teachers and in purchasing supplies and equipment. It also limits the amounts that can be used for purchase of technology and for development of purchasing technology and developing innovative methods. Low funding might explain the oft-repeated observation that charter schools are less innovative than the advocacy rhetoric in their favor had suggested. It is difficult for a school to invest in new methods when it can barely meet its costs. Even when schools of choice are stable enough to borrow from commercial lenders, as in the case of schools with long-term charters, their low income and strained balance sheets limit the amount of investment they can finance.

INEQUITABLE COMPETITION

All state charter school laws give chartering authority to local school boards. In such circumstances, schools of choice remain dependent on

their main competitors. Much the same is true of state boards of education, whose main loyalties are to the conventional public schools, and who have chartering or licensing power.

Though not all school districts take unfair advantage, they surely have mixed motives and opportunities to stack the deck against schools of choice. Districts can refuse to charter or license schools that are potentially stronger than some of the schools the districts now operate, and can attack schools whose financial management or community relations are no worse than many district schools. Districts whose own schools get a free pass from the fire marshal can urge that charter and voucher schools be examined closely, and can even tear down unused public school buildings in order to deny schools of choice access to them. The present author has seen instances of all these behaviors in the course of my studies of districts as charter school authorizers. All of them stack the deck against schools of choice, both by making them unnecessarily difficult to start and by casting doubt on their long-term survival.

However, such deliberate behaviors may not affect the supply side of choice as much as automatic assumptions about what risks a school of choice should bear all by itself. In general, there are many risks intrinsic to running a school of choice, whether publicly funded or supported by private tuition. These include:

- Lower than expected enrollment
- Inability to find or keep teachers
- Inability to find a suitable facility
- Variable costs set against fixed per-pupil tuition payments
- Conflicts and disruptions of school operations
- Changes in student demographics
- Disappointing test scores
- Failure of independent fundraising efforts
- Personal injury claims

However, there are risks specific to a school that depends on public funding programs. These include:

- Late or partial payments to schools
- Sudden increases in district charges for services
- Changes in rules about which families are eligible to choose
- New compliance requirements
- Absence of promised district services
- Unavailability or low quality of promised district services

These are risks that neither district-run nor fully private schools experience. They arise from the fact that public schools of choice are hybrid organizations with important links and vulnerabilities to government.

In other sectors, collaborations between government and private organizations recognize the main risks of doing business and allocate them between government and vendors, with the party most able to avoid the risk taking financial responsibility for failures. This is the case for government-owned, contractor-operated ("GOCO") arrangements in which private organizations operate government facilities. In fact, the foregoing lists of risks were adapted from the risk analysis that preceded a contract to design, build, and operate a public water system.

In education, however, no careful risk analysis has been done. Not all school districts duck all issues, but problems are largely handled ad hoc and on the basis of goodwill—which is sometimes plentiful and sometimes absent.

Lack of clarity about allocation of risk is probably the greatest supply-side barrier to the development of schools of choice. Until this is resolved, as in the case of the water system mentioned above, so that the government parties to a charter or licensing agreement accept responsibility for things only they can control, many risks to independent school providers are both significant and uncontrollable. Independent schools can buy insurance for personal injuries and sit-

uations where liabilities are well understood. But unpredictable district behavior probably renders many risks uninsurable.

A general risk-sharing scheme like the one developed for the public water system could make providing public schools of choice a much more viable proposition. At least two localities—Buffalo and San Diego—have considered using a risk analysis like the one sketched here as the basis for future school-chartering agreements.

UNSTABLE RULES

In theory, different forms of choice allow schools to exercise considerable autonomy over their instructional programs in return for clear accountability for results. Schools accepting vouchers should be able to operate as long as they perform well and attract students, and charter schools should be able to avoid the eroding effects of successive political mandates as long as they can demonstrate the expected student benefits.

Voucher and charter programs often start with many issues left undefined, however, and new regulations are often imposed after the fact. In Milwaukee, for example, opponents tried after the fact to impose new personal financial disclosure laws on board members of pre-existing private schools that accepted even one voucher student. California charter schools are constantly being re-regulated by the legislature and state education department, usually in response to teacher union pressures.

The vast majority of charter agreements leave accountability—what performance schools must demonstrate and what the school board or other public authority must do if a school meets or fails to meet its student performance goals—essentially undefined. Neither public officials nor charter school operators know for sure whether schools are obligated only by the specific terms of their charters or whether the schools must also abide by the rules that apply to other public schools. Consequently, charter schools in many states and localities are in danger of being drawn toward the dominant accountability practices of the public education system.

Some local and state administrators test charter school operators to see how much of the normal regulatory burden they will accept. Others—for example, advocates of special education—may be trying to preserve a regime of regulation whether or not disabled children and their parents have deliberately chosen the kinds of instructional environments available in charter schools. But most are probably only doing their jobs as they see them, reasoning that if other public schools must submit a particular report or plan, a charter school must be similarly obligated.

No business operates with completely stable rules, but few face as much uncertainty about what practices they must avoid and whom they must satisfy as do charter schools. If publicly funded voucher plans are similarly undefined and open to hostile reinterpretation, potential new school providers will be discouraged, if not entirely deterred.

UNCERTAIN ACCESS TO FACILITIES

For regular public schools, facilities costs are not counted as part of average per-pupil expenditure; they are carried in separate capital accounts. No such arrangements are made for charter schools or schools under public voucher plans: they must pay for facilities out of their basic operating funds. These costs compete directly with teacher salaries and other instructional expenditures and can severely limit schools' development as educational institutions.

Financial burdens aside, the growth and development of schools of choice is also constrained by the difficulty of gaining access to school buildings. Many school systems, even those in which some public schools are running below capacity, refuse to rent space to independently run schools. Some charter-friendly districts allow schools to petition for access to unused space in existing public schools but require the incumbent principal's approval. In a climate where many school administrators regard charter schools as unfair and unwarranted competition, such approval can be very hard to obtain. Despite the Chicago district's strong support of a district-initiated charter

school program, the vast majority of that city's new schools have had to lease or buy and renovate private space.

As Linda Darling Hammond and Jacqueline Ancess have written:

The impact of space on the successful launching of a new school is overriding. It impacts budget, the delivery of necessary materials, the quality of education, the morale of the staff, [and] the school's credibility with its parents and students. . . . [S]chool directors devote considerable attention to site location and design, diverting them from their role of instructional leader.

UNPREDICTABLE COSTS

One risk left out of the foregoing analysis is the possibility that handicapped children needing extremely expensive services will enroll in a school of choice. A school that receives a fixed amount for every pupil enrolled, as most voucher and charter schemes provide, has little flexibility to spend several times the per-pupil average on a small number of students. The average charter school educates 256 students on about \$5,000 each year. Enrollment of just one handicapped student who needs \$50,000 in special services could force the school to shake 7 percent out of the remainder of its budget.

Schools that charge private tuition manage the risk of such an event in two ways: by monitoring student progress closely so that none falls behind far enough to need special education services and by urging parents whose children need extremely expensive services to enroll in public schools. The former strategy is available to publicly funded schools of choice, but the latter might not be. Open enrollment and admissions lottery requirements might make it impossible for schools of choice to avoid enrolling such students. Moreover, schools of choice can encounter major public relations problems if opponents can demonstrate that they "cherry pick" easy-to-educate students.

Some school districts (e.g., San Diego) help charter schools manage these risks, essentially by charging a per-pupil amount for special education coverage. Some charter schools are also forming

risk pools. However, many charter and voucher schools are still forced to “go naked” with respect to this one source of potentially disastrous costs.

THE ENTREPRENEURIAL LEARNING CURVE

Aspiring school providers also face a serious, if temporary, shortage of innovative ideas. A hostile operating environment does not attract heavy R&D investments or reward a lot of risk taking. As the environment is more receptive to schools of choice, innovation is more likely.

To date, new schools of choice have been relatively conventional. For-profit educational management organizations (EMOs) have taken advantage of process controls and economies of scale to try to create a marginally more effective product. Some newer groups are trying to reproduce the studious climate and focus on instruction typical of Catholic schools, or to use small school size as a way of personalizing instruction. All these approaches have market appeal, and when well implemented lead to popular schools. However, none of them creates a dramatically more effective or lower unit-cost approach to instruction than public school systems now provide, at least in some of their schools.

Truly innovative approaches to schooling—those that dramatically reduce some costs (e.g., online schools that do not require expensive facilities), use more productive mixes of teachers and technology, or increase students’ learning time without corresponding increases in instructional costs—could create real competitive advantages for schools of choice. If demonstrated well enough to attract large numbers of parents, new approaches could generate profits and attract private financing.

Innovating in these ways is easier said than done. New American Schools, a business-funded private initiative, set out to develop bold new school models but ended up being captured by progressive educators who thought school effectiveness could come only from teacher reflection and deliberation—costly activities that do not affect students directly. The fact that many new charter schools have

also adopted the same ideology probably explains their slow start-ups and low initial performance.

There is a great deal of private innovation in education, but most of it is focused on existing public schools. Companies develop materials and instructional modules that public school districts can buy and implement smoothly, consistent with their cost structures and regulatory constraints. Since school districts contract out for many more such "components" than for whole schools, most innovation has focused on modules and widgets. Only Edison and a few nonprofit EMOs have tried to develop and sell whole schools.

Many of the new components are high quality, and might be combined into overall school models that have effectiveness or cost advantages. But they have not been combined. It is as if the aerospace industry had created innovative new engines, flight controls, materials, and aerodynamic surfaces, but no one had tried to combine all of them into a new kind of aircraft. In education, there is a need for systems integrators, like the Lockheed Skunk Works, that combine new components into designs for whole schools.

The entrepreneurship necessary for such innovations is scarce now, but it is likely to arise if the terms of competition are improved.

HOW BARRIERS CAN BE OVERCOME

Publicly funded schools of choice have important potential advantages over district-run schools. These include greater discretion over use of funds, ability to use time, money, and instructional technologies in innovative ways, and freedom to hire teachers and to compete for people of high ability by offering attractive packages of working conditions and pay. Such schools also have access to philanthropic investment and to private risk capital.

However, a profoundly hostile competitive environment makes it unlikely that schools can exploit these advantages. Highly capable organizations are less likely to try providing schools if the deck is stacked against them, and schools of choice that receive less funding or must carry greater regulatory burdens than their competitors are

unlikely to thrive. Because so many supply-side barriers are rooted in public policy, or in the lack of market provision of key goods and services, individual schools cannot overcome them. Overcoming supply-side barriers requires concerted action by school choice policy activists, philanthropists, businesses, and school heads.

POLICY ACTION

More than anything else, schools of choice need an equitable and stable policy environment so that they can compete fairly with district-run schools and with one another. This includes school financing policies that allow all schools in a locality to receive the same number of dollars for educating a particular student. These amounts might vary from student to student, with additional amounts available for hard-to-educate students, such those who enter school not speaking English. But the amount available for a given student should not vary from school to school.

Other elements of a level playing field include common licensing standards for all schools (whether operated by school districts or independent organizations), common measures of student performance for all schools, and uniform standards for determining whether a school's performance is sufficient to warrant its continued eligibility to receive public funds. This implies, ultimately, that public oversight be neutral among schools regardless of who runs them, something difficult to achieve when conventional school districts oversee schools of choice.

Finally, a level playing field requires equality on the cost side. When district-run schools get facilities and maintenance for free while schools of choice must pay for these things from the tuitions they receive, schools of choice operate at a financial disadvantage. Totally separating the ownership of school facilities from the operation of schools, including money for rent in per-pupil payments to schools, and making all schools rent their facilities would remove a major supply-side dampening factor for schools of choice.

An equitable and stable policy environment opens the door to productive philanthropic investment and business services innovation.

PHILANTHROPY

The most important role for philanthropy is to pay start-up costs for new schools and organizations that can provide needed services. The one-time costs of organizing a school—establishing curriculum and instructional methods, hiring and orienting staff, establishing and renovating facilities, recruiting parents, arranging administrative services, and obtaining legal advice and establishing contracts—must be paid before the school receives any tuition income. Schools might borrow money on anticipation of tuition income, but this puts them into a financial hole that existing schools can avoid.

In recognition of these one-time costs, the federal government has established a small program to pay charter school start-up costs. This program's funds can cover only a modest number of new charter schools each year and are available only to schools designated by state agencies. Philanthropic funds, with an average of \$100,000 one-time grant for each new school, could greatly accelerate the rate of new school start-ups. Philanthropic funds can also facilitate the founding of service organizations to provide incubation, financial management, and other back-office services for schools of choice, to search for and train individuals capable of leading schools of choice, and to provide risk management.

Like schools, such organizations must ultimately survive on the income derived from doing regular business. However, philanthropic investments make it possible for needed elements of the supply system to emerge, and to start on a sound basis.

BUSINESS INNOVATION

District-operated public schools depend on district central offices to provide services to severely handicapped children, financial services, building maintenance, human resources, employee benefits, food and

transportation, legal representation, management consulting, crisis intervention, and instructional materials. Schools of choice must obtain these services for themselves, and pay for them out of their per-pupil income. One argument for choice is that it can increase the share of funds spent directly on instruction. It is argued that school districts, lacking competition, spend too much on centrally administered services and tax all schools for services only a few need. If schools purchased only what they needed, they could pay for fewer services and get those they buy more cheaply than districts now provide them.

This argument presumes that vendors are readily available or could appear as quickly as growing numbers of schools required them. This is almost certainly true of basic business and facilities services. But for education-specific services—e.g., tutoring, special education services, leadership training, and advice on transformation of troubled schools—few qualified providers now exist. School districts have monopolized provision of these services, and private schools have made their own very specific arrangements.

One form of business innovation is insurance for the special risks borne by schools of choice. For example, new schools would be far more likely to emerge and thrive if the costs of special education were under control. A special education insurance program could allow schools to know in advance what special education would cost each year. No private insurance underwriter has offered such insurance, for two reasons. First, school districts have covered their own costs, largely by robbing other general-education accounts to pay for their burgeoning special education offices. Second, information about individual schools' expenditures has been hidden in district budgets that record costs by function, not by school.

An insurance industry could emerge rapidly, however, if philanthropies offered to support start-up insurance funds and pay excess losses for small pilot projects. Charter and voucher-funded schools could buy insurance for a few hundred dollars per pupil and have their costs adjusted annually on the basis of experience.

ENTREPRENEURIAL LEARNING

Most important of all, a more positive climate for new schools, coupled with unleashing of demand, will stimulate the development of new schools and the stresses of competition that drive refinement and innovation. Public school district monopolies have prevented the virtuous cycle of demand driving supply and supply improvements driving demand. Although existing charter and voucher programs have made such a cycle theoretically possible, their small size and highly regulated character have kept it weak.

CONCLUSION

In the long run, the supply side of choice will depend on policy initiatives that create equitable funding and a regulatory neutrality for schools of choice, and on investments made by foundations, nonprofits, and companies in support of new schools.

